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Committee on Small Business,
House of Representatives

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SMALL BUSINESS

Access to Surety Bonds

Statement of Jim Wells, Associate Director,
Housing and Community Development Issues,
Resources, Community, and Economic
Development Division



Mr. Chairman and Members of the Subcommittee:

We are pleased to discuss the use of surety bonds in the construction industry and to present information we collected through a survey of small construction firms. Because we are still analyzing the data we obtained through our survey, this information must be viewed as preliminary. Surety bonds ensure that should the bonded contractor default, the construction project will be completed and the contractor's employees and material suppliers will be paid. Federal law currently requires contractors to provide certain types of surety bonds on all federal construction contracts worth over \$25,000. Most state and local governments and some private-sector lenders also require firms to be bonded. Surety companies, or the entities that issue surety bonds, decide whether firms have the necessary experience and financial capability to perform a given job and to qualify for a bond.

Small businesses have asserted that the decisions that surety companies make on bonding frequently impede the development of small firms, especially those owned by women and minorities. However, limited data existed on this issue. As a result, the Small Business Credit and Business Opportunity Enhancement Act of 1992 directed us to survey small construction firms for information on their experiences in obtaining surety bonds and to report this information to the House and Senate Small Business Committees. As required by the act, we focused primarily on small firms; that is, those firms meeting the Small Business Administration's (SBA) size standards for eligibility in its programs.¹

The information we will be presenting today is based on the results of a questionnaire we sent to 12,000 construction firms randomly selected from a list maintained by Dun & Bradstreet of 683,198 construction firms. About 5,000 firms responded to the survey. Because of this low response rate, we conducted a follow-up telephone survey of a sample of the firms that did not respond to our survey, and found that nonrespondents were less likely than respondents to use surety bonds.

It is important to remember that we are only presenting information reported to us by the firms. We did not verify this information.²

¹SBA requires that annual average revenues, over a 3-year period, not exceed \$17 million for firms in general building construction (e.g., commercial and industrial construction) and heavy construction (e.g., roads and bridges), and \$7 million for special trade contractors such as plumbers, painters, electrical contractors, and concrete masons.

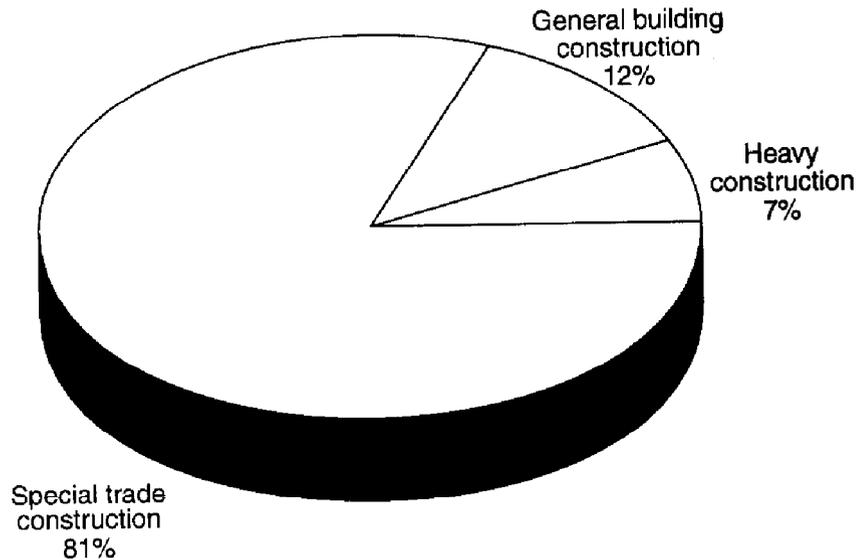
²Since our study relied on a sample of firms, the data are subject to sampling error. Sampling error is a mathematical calculation to express how much the percentage could vary if we conducted the survey again. For all the percentages we discuss,

Our testimony today will focus on selected information we obtained through our questionnaire. Among other things, we will discuss the (1) percentage of firms that obtained bonds, (2) reasons some firms were given that bonds were denied, (3) additional conditions some firms had to meet to obtain surety bonds, and (4) changes in requirements for surety bonds on federal construction contracts. We will issue a report later this year that will present statistical information on the characteristics and bonding experiences of small construction firms. Among other things, the report will discuss differences in experiences by the size of the firms and the ethnicity and gender of the firms' owners.

FIRMS THAT OBTAINED BONDS

Special trade contractors, such as plumbers, painters, electrical contractors, and concrete masons made up about 80 percent of the small construction firms to whom we mailed our survey. (See fig. 1.)

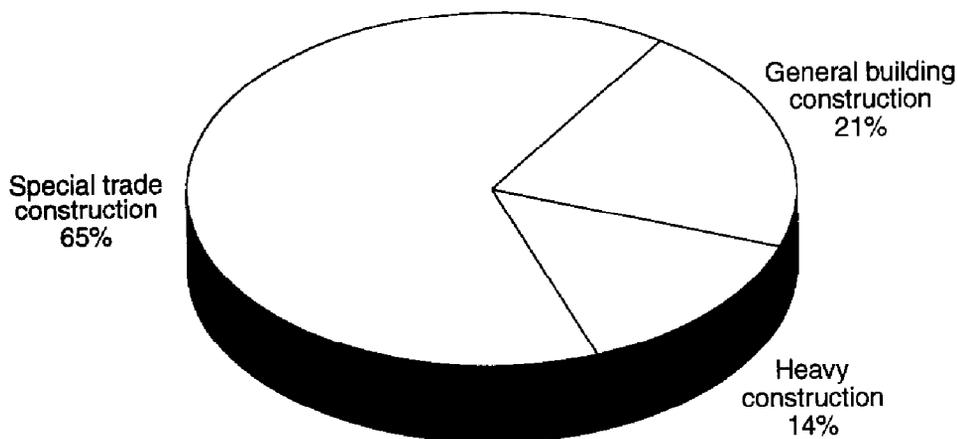
Figure 1: Specialization of Firms Surveyed



the sampling error is less than 5 percent. Because about 50 percent of the firms responded to our questionnaire, we can generalize to about half of the small construction firms.

At the same time, about two-thirds of the small construction firms that had obtained bonds were special trade contractors. (See fig. 2.)

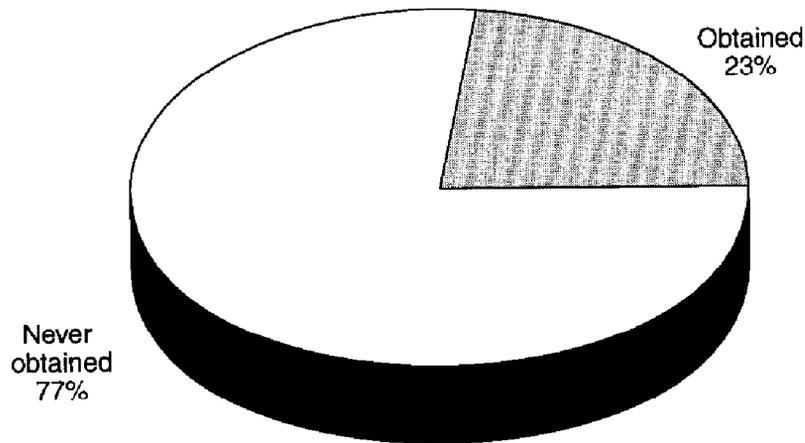
Figure 2: Specialization of Firms That Had Obtained Bonds



OVERALL RATE OF OBTAINING SURETY BONDS

We estimate that at least 23 percent of small construction firms had obtained bonds and that a maximum of 77 percent of the firms had never obtained a bond. (See fig. 3.)

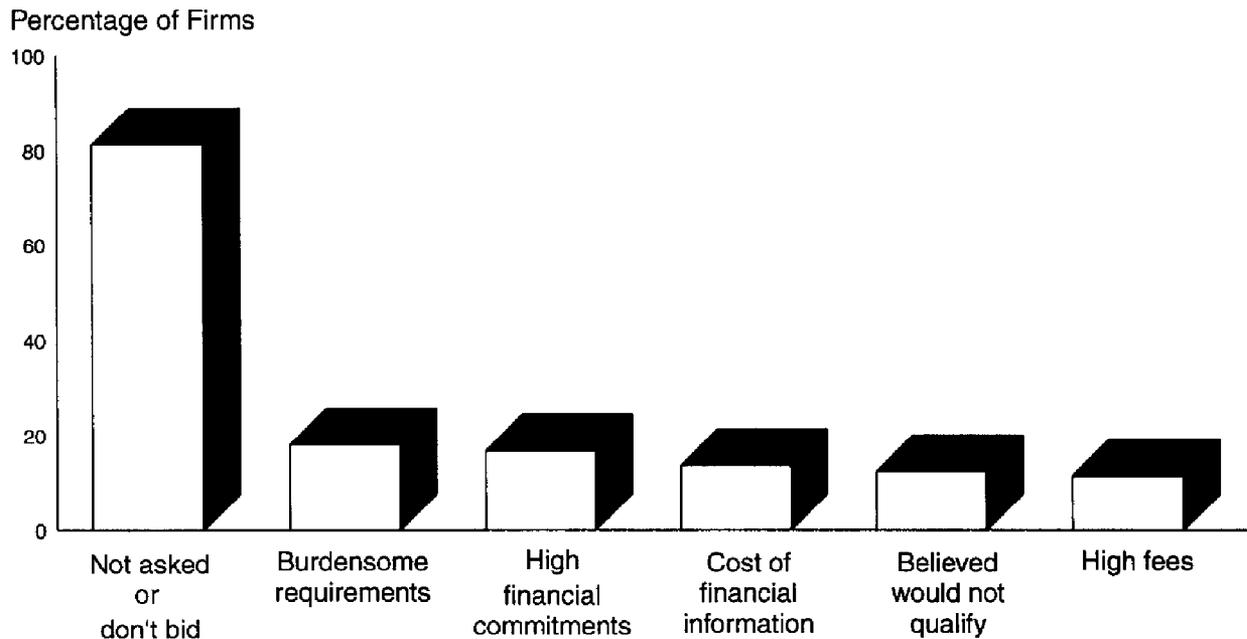
Figure 3: Percentage of Small Construction Firms That Had Obtained Bonds



REASONS FOR NOT OBTAINING BONDS

The reason that small construction firms cited most frequently for not obtaining bonds was that they were not asked to obtain a bond or did not bid on work that required bonding. Five other reasons for not obtaining bonds were cited by at least 10 percent of the firms. These firms said that (1) the surety company's requirements for a bond were too burdensome, (2) the financial commitment required for a bond was too high, (3) they could not afford the cost of preparing financial information for the surety company, (4) they believed they would not be able to get a bond, and (5) the fees charged by sureties made it unprofitable for the firms to do bonded work. (See fig. 4.)

Figure 4: Reasons Why Small Construction Firms Did Not Obtain Bonds



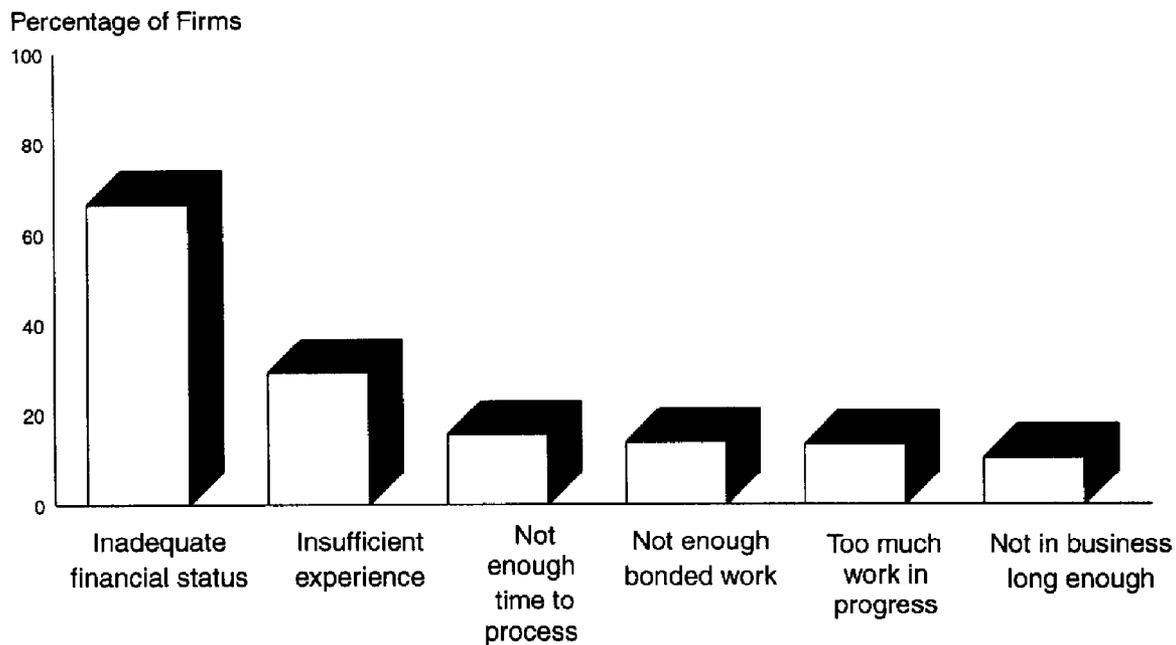
RECENT EXPERIENCES WITH BONDING

We asked the firms in our survey that had obtained bonds about their recent experiences. Specifically, we asked the firms whether, between 1990 and 1993, a surety company had ever denied their request for a bond or imposed certain conditions before approving a bond.

Bond Denials

Overall, we found that about one in five small construction firms that obtained a bond between 1990 and 1993 had also been denied a bond during those years. The firms most commonly cited two reasons they were given for their last bond denial: the firm's financial status, such as net worth and operating capital, was not good enough for the bond it requested and/or the firm had never performed the kind of work or size of project called for in the contract. At least 10 percent of the firms in our survey also reported they were told the following reasons for being denied bonds: (1) the surety company did not have enough time to process the bond, (2) the firm had not performed enough bonded work, (3) the surety company would not issue more bonds until the firm's current work was completed, and (4) the firm had not been in business long enough. (See fig. 5.)

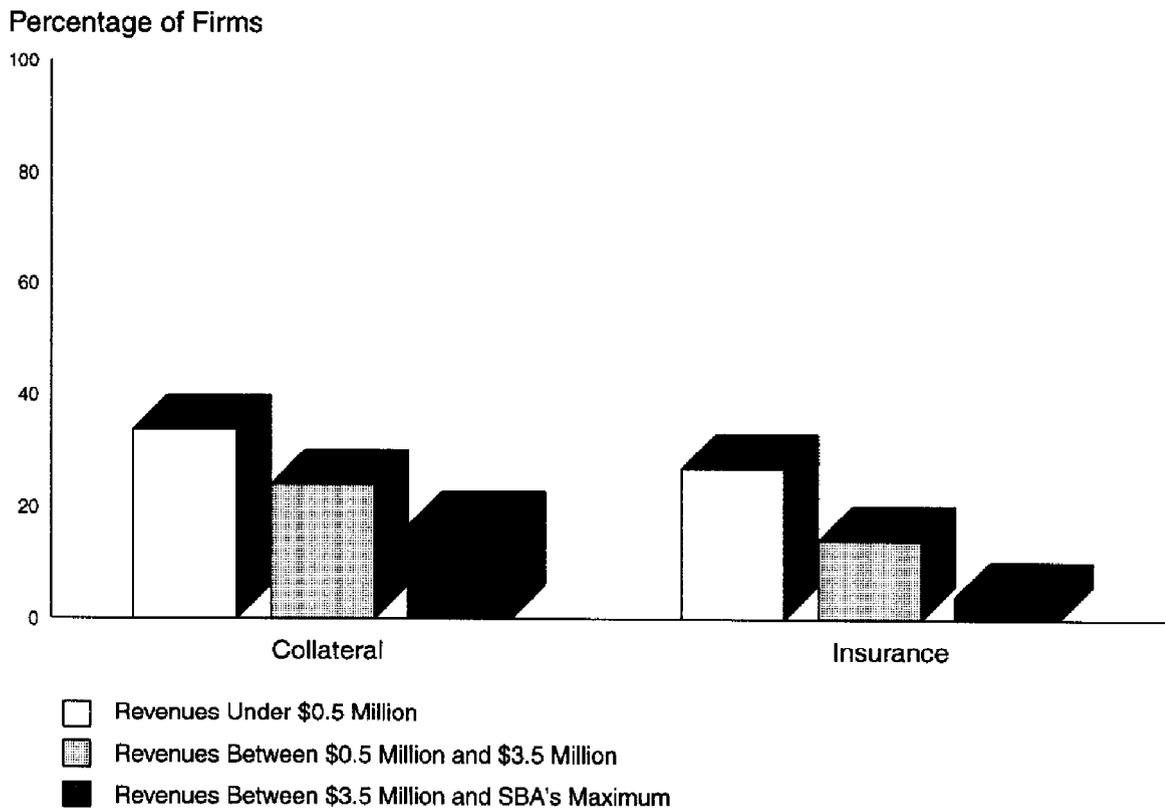
Figure 5: Reasons Firms Were Given for Bond Denials Since 1990



Experiences Cited by Construction Firms of Different Sizes

The respondents to our survey differed according to the size of the firm in whether they reported having to put aside collateral to obtain bonds. About 34 percent of the firms with annual revenues under \$500,000 said they were asked to set aside collateral, compared with about 24 percent of the firms with annual revenues between \$500,000 and \$3.5 million and about 17 percent of the firms with annual revenues over \$3.5 million. Size also affected whether respondents reported having to purchase insurance. About 27 percent of the smallest construction firms reported they had to purchase insurance, compared with about 14 percent of the medium-sized firms and about 4 percent of the larger firms. (See fig. 6.)

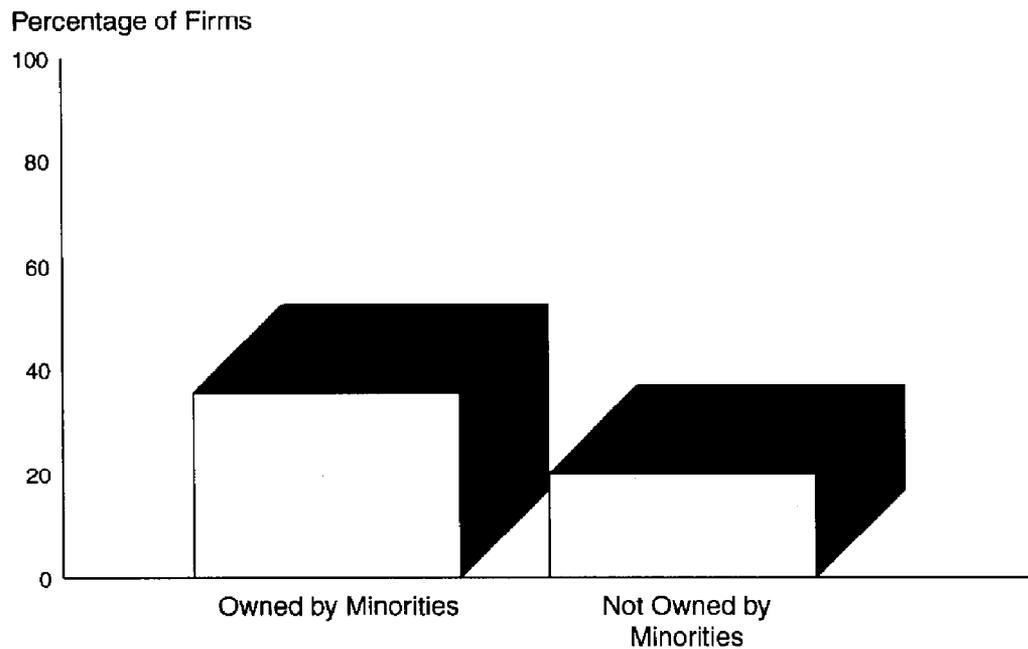
Figure 6: Collateral and Insurance Required, by Size of Firm



Experiences Cited by Firms
Owned by Minorities and Firms
Not Owned by Minorities

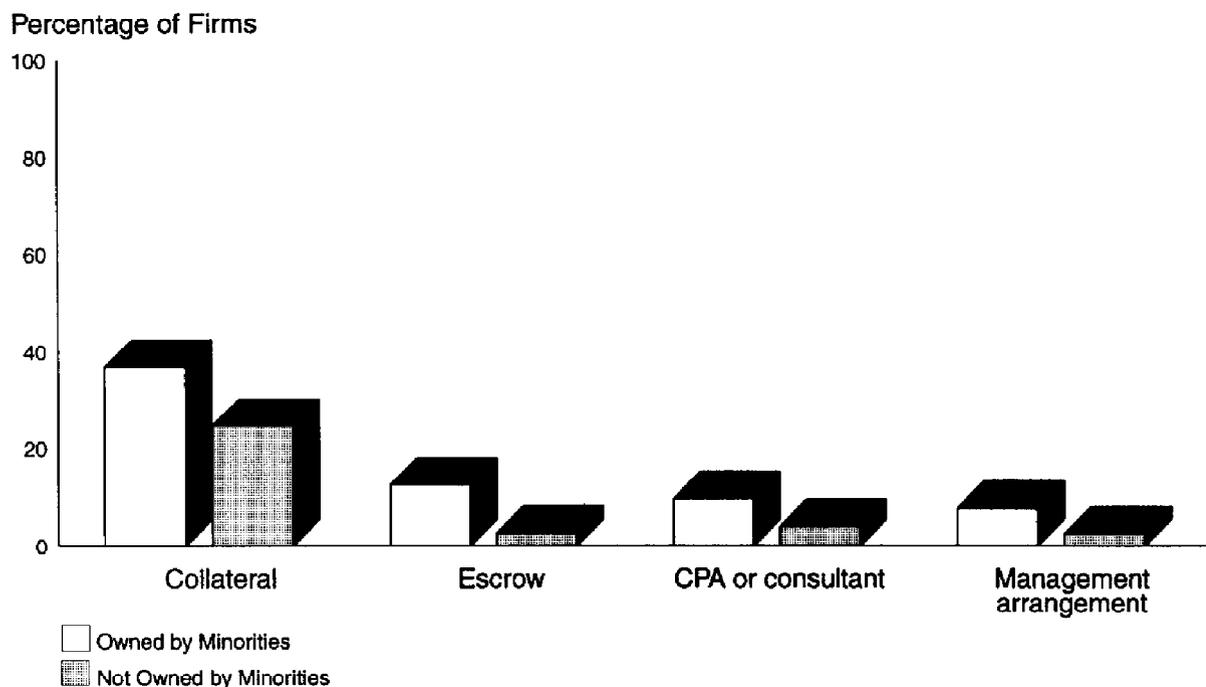
About 36 percent of the bonded small construction firms owned by minorities reported to us that they had been denied a bond since 1990. This compares with about 20 percent for firms not owned by minorities that had been denied a bond. (See fig. 7.)

Figure 7: Bond Denials Reported



Our questionnaire also indicated that minority-owned firms reported more often than firms not owned by minorities that they had to (1) set aside collateral, (2) establish an escrow account controlled by the surety, (3) hire a certified public accountant (CPA) or a management or consulting firm selected by the surety to manage the contract, and (4) enter into an arrangement that allows the surety to manage the job even when the firm is not in default. (See fig. 8.)

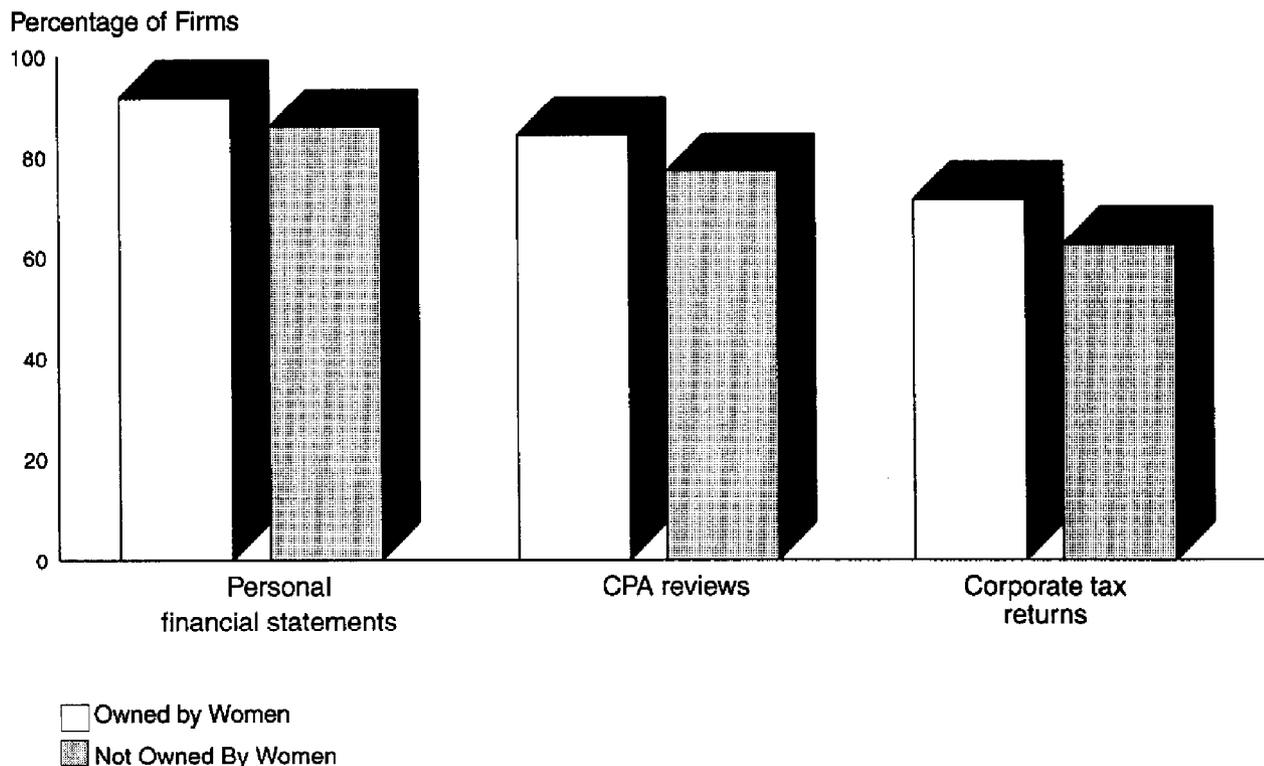
Figure 8: Conditions Required



Experiences Cited by Firms
Owned by Women and Firms
Not Owned by Women

There are three areas in which firms owned by women and those not owned by women reported preliminary differences in the documents they had to provide to obtain a bond. (See fig. 9.) About 92 percent of the women-owned firms reported that they had to provide personal financial statements, compared with 86 percent of the firms not owned by women. Similarly, 84 percent of the women-owned firms reported that they had to provide a CPA-reviewed financial statements, compared with 77 percent of the firms not owned by women. Also, about 71 percent of the firms owned by women indicated that they had to provide corporate tax returns, while about 62 percent of the firms not owned by women had to do so.

Figure 9: Documents Provided

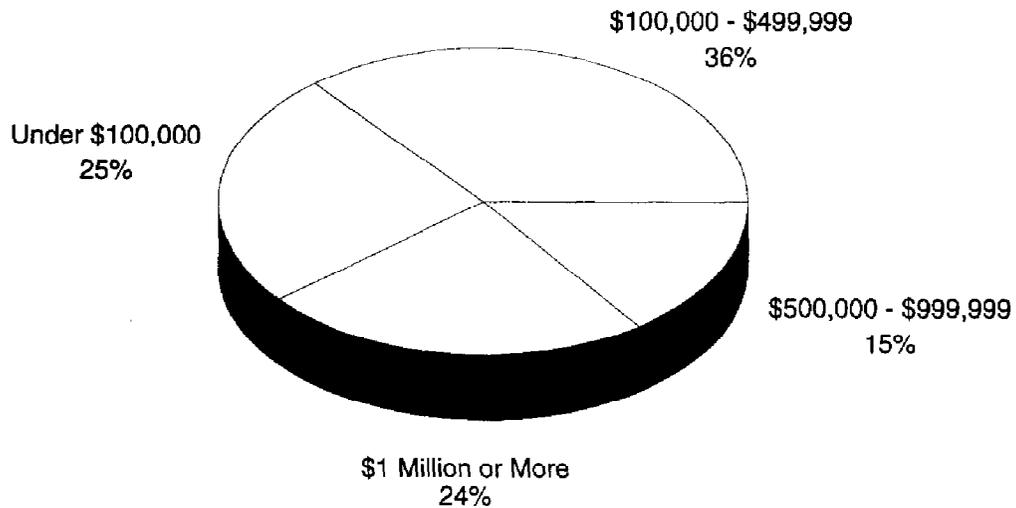


FEWER FIRMS WILL REQUIRE BONDS IN THE FUTURE

To revise and streamline federal procurement, the Congress passed the Federal Acquisition Streamlining Act of 1994. One of the act's provisions increased the minimum value of federal construction contracts that require surety bonds from \$25,000 to \$100,000, effective in October 1995. This new bonding threshold could eliminate the need for bonding for a number of small construction firms doing business with the federal government. In 1993, about 25 percent of the small construction firms in our survey did not obtain bonds for \$100,000 or more. (See fig. 10.)

Figure 10: Largest Bond Obtained in 1993

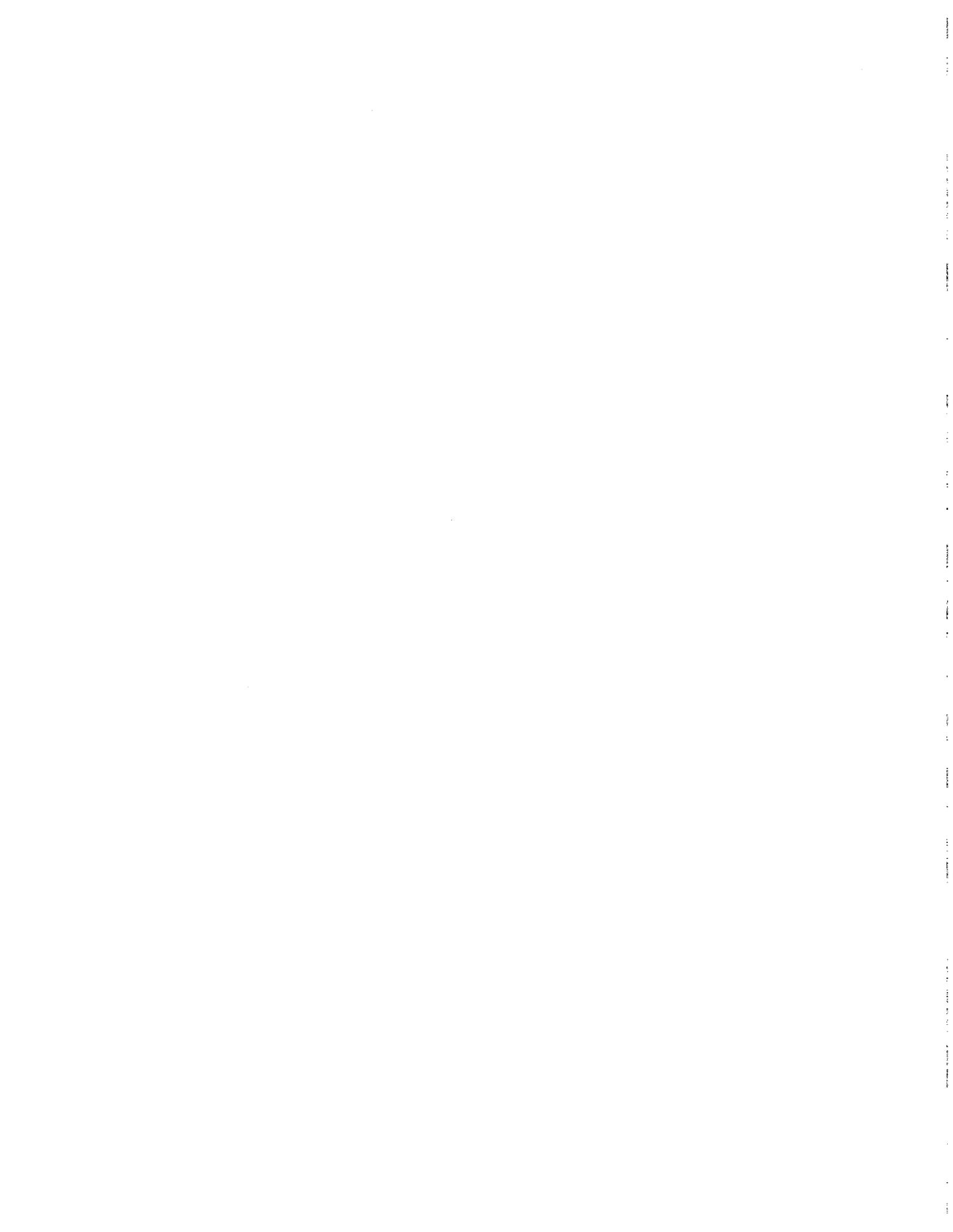
Percentage of Firms



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Mr. Chairman, this concludes our statement today. We are completing our analysis of the survey results and plan to issue our report later in this year. We would be glad to answer any questions that you or Members of the Subcommittee may have.

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